



Simplifying U.S. Taxation of Foreign Activities Through Subpart F Reform

Issue

The subpart F provisions of the Internal Revenue Code, designed to tax income earned outside the U.S. by U.S.-controlled foreign corporations, hinder U.S.-based multinational corporations from being globally competitive. The need for these provisions has become questionable, in light of improved U.S. and foreign transfer pricing enforcement.

Background

In general, U.S. tax is imposed under subpart F not only on a foreign subsidiary's passive income (interest, dividends, etc.) but also on income earned from certain active business transactions with related persons. For example, U.S. tax is imposed on the income of a foreign subsidiary from purchasing goods from legal entities within the multinational group and reselling them outside its country of incorporation.

The 1962 legislative history to subpart F reveals that the related person provisions were targeted at transfer pricing abuses. Since 1962, however, the ability of the IRS and foreign tax authorities to combat transfer-pricing abuses has improved dramatically. The IRS has issued increasingly detailed transfer pricing regulations to provide guidance, and Congress has enacted stern penalties for non-compliance. As a result, the profits of the various members of a U.S.-based multinational group are much more likely today to be properly allocated based on real economic factors (such as the functions performed, investments made, and risks borne).

Additionally, in the early 1960's, foreign subsidiaries of U.S. multinationals typically operated only in their country of incorporation, in part because each country presented a unique market. With the rise of globalization, the falling of trade barriers (e.g., the economic integration of the EU countries), and improvements in technology, foreign subsidiaries can now more efficiently and effectively conduct business on a regional or even global basis. For example, many multinational groups now seek to centralize functions in regional hubs or service centers. However, subpart F imposes a tax cost on foreign subsidiaries that operate outside their country of incorporation, and as a result, they are penalized for acting in the most economically efficient manner (e.g., by operating on a regional basis). Accordingly, U.S. multinationals are forced to either pay the extra tax cost or to needlessly duplicate functions in multiple foreign countries.

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Policy Considerations

The subpart F related person provisions create unnecessary complexity, which leads to excessive taxpayer compliance costs, increased IRS audit costs, and additional burdens on the courts.

In all likelihood, subpart F related person provisions do not generate significant revenue for the U.S. government because multinational corporations generally manage to avoid subpart F inclusions when the offshore income is earned in countries with a tax rate lower than the U.S. tax rate. In contrast, when subpart F income is earned in countries with a tax rate in excess of the U.S. tax rate, and the U.S. multinational has excess foreign source income to absorb these taxes, the U.S. multinational is all too happy to include this income in its U.S. corporate tax return because the foreign taxes are fully credited against the U.S. tax liability.

As mentioned above, improved transfer pricing guidance and enforcement (including stiff penalties) have caused U.S.-based multinational corporations to pay much closer attention to the appropriate cross-border allocation of income. In other words, the 1962 concern about artificial transfer prices has been adequately addressed through other means. As a result, the subpart F related person provisions are no longer needed. Moreover, as companies continue to adopt integrated business models dictated by the global marketplace, such provisions act as a hindrance to U.S. competitiveness.

In July 2002, House Ways and Means Committee Chairman Bill Thomas (R-CA) introduced an international tax reform bill (H.R. 5095, 107th Congress). H.R. 5095 included subpart F and foreign tax credit reforms, including proposals to repeal the foreign base company sales and services rules. Chairman Thomas is expected to reintroduce H.R. 5095 during the 108th Congress with some modifications. Separately, a Senate Finance Committee working group led by Sen. Orrin Hatch (R-UT) and Sen. Bob Graham (D-FL) is developing international tax reform recommendations.

Recommendation

The SVTDG recommends that the foreign-based company sales and foreign-based company services income rules of subpart F be repealed in their entirety. This would be an effective way to resolve the confusion surrounding various other issues, such as contract manufacturing and the treatment of the EU as one country. Consistent with such repeal, the SVTDG further recommends that an exception from subpart F be provided for any active financing, active rental or active royalty income.